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MEXICO: THE NEXT SOUTH KOREA?

HOW BROOKS BROTHERS KEEPS STRUGGLING WITH CHANGE

WHY GORBACHEV IS SPLURGING ON SUBMARINES

JULY 9, 1990

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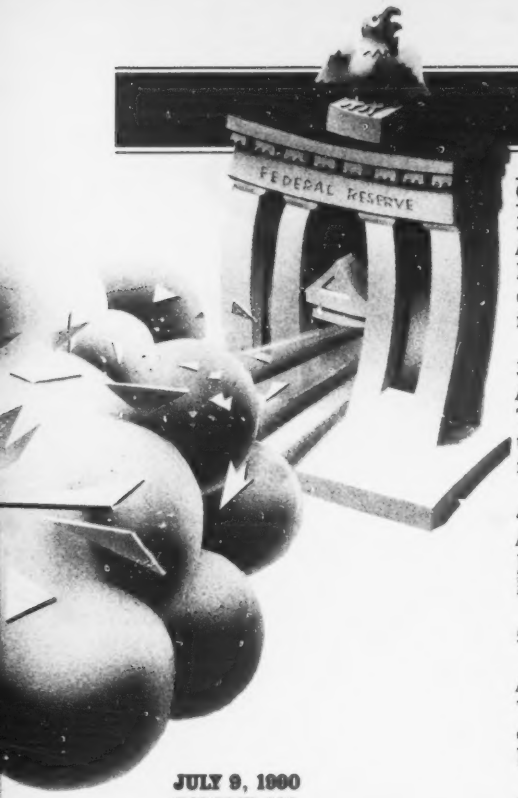

JULY 9, 1990
VOLUME 146
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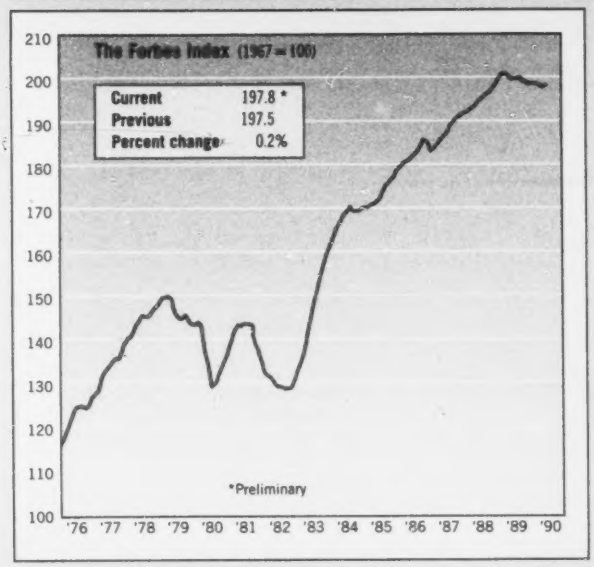
The Forbes Index



Consumers are consuming less. May retail sales were off 0.7% from April. On an inflation-adjusted basis, retail sales are actually 0.4% lower than they were 12 months ago. Consumer installment credit is up, but only by a modest 1.2% so far this year. One reason for the sluggish growth in consumer lending is the weakness in auto sales. Industrial production crept up 0.6% in May while the Consumer Price Index rose 0.2%. The preliminary Forbes Index shows a 0.2% gain in May, but this figure is likely to change once the remaining components are reported.

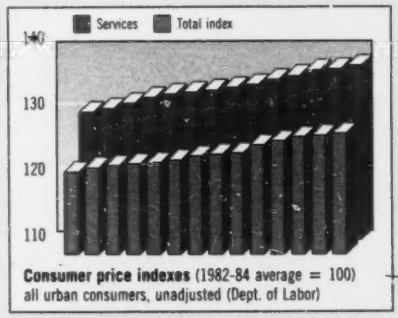
Other key rates	Source	Status
Prime rate	Chase Manhattan Bank	10.0%
Auto sales year to date vs. 1989[1]	Ward's Automotive	-6.0%
Index of leading indicators April vs. March	Dept of Commerce	-0.2%
Trade balance last 12 months ending April 1990	Dept of Commerce	-$93 bil
Producer price index May vs. 1989[2]	Dept of Labor	3.1%
GNP 1st quarter vs. 4th—annualized growth	Dept of Commerce	1.3%
NBER Experimental Recession Index[3]	Natl Bureau of Economic Research	6.0%

[1]U.S.- based manufacturers, excludes imports, as of 6/10/90. [2]Finished goods. [3]April 1990.

Index Components

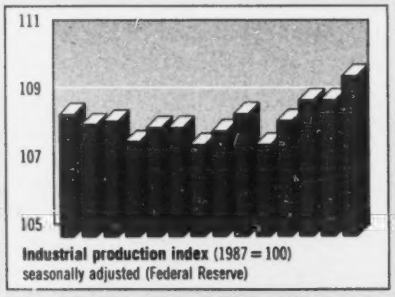
The Forbes Index is a measure of U.S. economic activity composed of 8 equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, new housing starts, total retail sales, the level of new orders for durable goods compared with manufacturers' inventories, personal income, total consumer installment credit.

To measure these 8 elements, FORBES monitors 10 series of U.S. government data. The last 14 months' data for each series are presented below.



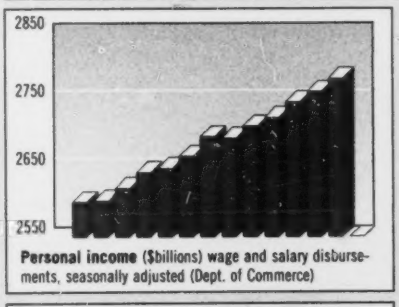
Consumer price indexes (1982-84 average = 100) all urban consumers, unadjusted (Dept. of Labor)

Manufacturers' new orders and inventories ($billions) seasonally adjusted (Dept. of Commerce)



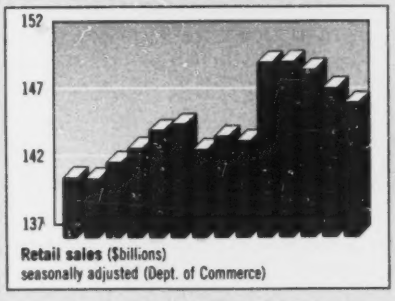
Industrial production index (1987 = 100) seasonally adjusted (Federal Reserve)

New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)

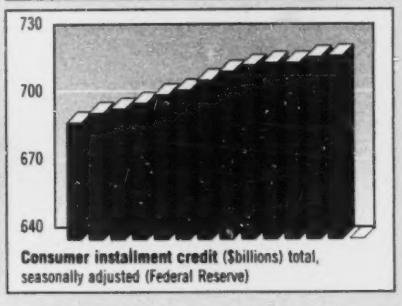


Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)

New unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)



Retail sales ($billions) seasonally adjusted (Dept. of Commerce)



Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

Forget Eastern Europe. The next great economic miracle will take place right on our borders. Mexico is on its way to becoming an economic powerhouse.

A revolution you can invest in

Steven Rubin/J.B. Pictures

Mexico City
No evidence of significant unemployment.

By David Goldman

MEXICO'S STOCK MARKET index has approximately doubled since July 1989, outperforming every other market in the world. Is the party over? Not by a long shot. By 1993 the Mexican market could well rise to four times its present level. Under President Carlos Salinas de Gortari, Mexico is set to repeat the success story of South Korea but on a far grander scale. Robert L. Bartley, editor of the *Wall Street Journal,* says he believes the Salinas team is the best in the world. So far as economics is concerned, the 88 million Mexicans will have far greater impact on the world of A.D. 2000 than will the 133 million citizens of Eastern Europe.

That President Salinas feels strong enough to talk with President Bush about a possible free trade zone with the U.S. speaks volumes about his determination and ability to break with the sterile economic nationalism that has held his country back.

On May 14 Mexico's Congress voted a constitutional amendment to privatize banking. Future historians may pinpoint this date as the day that an undisputed national consensus emerged in favor of what I shall call Salinastroika—a peaceful revolution promising changes as profound as those of 1910-17 in Mexico's political and economic life. Eastern Europe's path to political maturity may be shorter or longer than Mexico's, but it has just set out on the learning curve, while Mexico is heading up its sweep.

For U.S. business people and investors, Mexico is a far more interesting story this time than Eastern Europe is.

Mexico still has big problems, including the persistent 14% annual crawling-peg devaluation of the peso, and no one can predict when they will be solved. The pace of policy change during the past 12 months, though, provides cause for optimism. A senior Finance Ministry official told me, "The only thing that is not negotiable is the virginity of the Virgin of Guadalupe [Mexico's patron saint]. That stays. Everything else is on the table."

Already swept off the table is much of the agenda of Mexican statist economics. This includes bank nationalization, high tariffs, nontariff barriers, redistributionist tax policies, industrial regulation, state enterprises, and so on. A North American free trade zone is on the table for national debate, and there are hints that Mexico may even encourage some private oil exploration.

The most remarkable aspect of Mexico's ascent during the past two years is the way in which the supposedly insuperable problems of foreign debt and government deficits melted away, virtually unnoticed. Inflation has been brought to below 20% from over 150%, the peso is stable, foreign-

Cindy Karp/Black Star

Carlos Salinas de Gortari, President of Mexico
A Mexican success story to rival, perhaps surpass, that of South Korea?

exchange reserves are increasing, and the short-term Treasury bill rate is down to 34%—despite the fact that Mexico has received virtually no new loans from commercial banks.

What happened? Under Salinas' predecessor, International Monetary Fund-imposed austerity was tried and failed. Salinastroika is succeeding because it reduced government's role in the economy and helped restore international confidence in the Mexican economy. A swing of perhaps $10 billion in the current account between 1987 and 1989 was financed by inflows of private nonbank capital, with room to spare. With interest rates down to about a fifth of their 1987 peak level, the government can comfortably service the national debt, which absorbed 60% of federal spending in 1988. Mexico has demonstrated that it does not need bank financing (except for the usual short-term purposes), as long as it offers foreign and domestic capital opportunities to make money.

Mexico has found that it has no shortage of capital. To what extent the investment inflows represent repatriated flight capital or new investments by foreigners is irrelevant. The expectation of a drastic improvement in the tax and monetary environment was sufficient to attract ample capital to finance a substantial trade deficit. As the effects of the new policy environment translate into higher rates of return, capital will be waiting in line at border crossings to get in.

Perhaps the most important single factor weighed into these expectations has been the standing of President Salinas himself. In the July 1988 elections Salinas took a bare majority in a three-way race. To accusations of vote fraud, Salinas promised political reform, and made good on it. The July 1989 election of a National Action Party (PAN) candidate to the governorship of the state of Baja California broke the PRI's half-century monopoly on the state capitals, establishing the PAN as a loyal right opposition to Salinas. The leftist Revolutionary Democratic Party, still preaching protection and income redistribution, has floundered. Its leader, Cuauhtémoc Cárdenas, son of one of Mexico's most beloved past presidents, has found no means to block Salinas' initiatives. The president's political reform program, which establishes multipartisan election commissions, seems sure to pass Congress with the support of the right-of-center PAN. Most important, Salinas' big congressional majority for bank reprivatization shows that the president's man-

David Goldman is senior economist at Polyconomics, Inc. in Morristown, N.J. The article is adapted from a Polyconomics report, "Salinastroika: Investing in the Mexican Revolution," a summary of the book-length study "Mexico 2000."

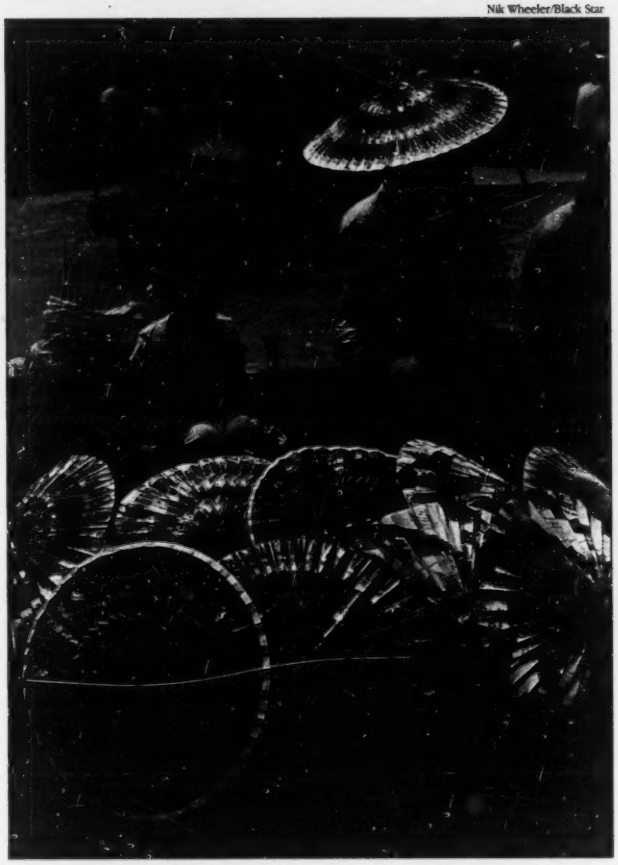
date is secure.

The next step will be to bring above ground the underground economy, which has kept much of Mexican growth invisible. During the 1980s Mexico's labor force grew at a rate approaching 1 million per year, while real GDP (as counted by the government) barely changed. Yet no one can find evidence of significant unemployment outside of depressed rural areas, proving that the new entrants to the labor force found jobs. A Polyconomics study concluded that the official statistics underestimated the GDP by 25% by failing to allow for the huge amount of business done off the books. Officially, the economy grew by 3% in 1989, although there are indications that figure may have been larger.

All the unreported growth took place in small businesses—perhaps 1.5 million of them—which proliferated in the so-called informal economy. The casual traveler sees part of this, in the form of tens of thousands of street-corner businessmen selling everything from tacos to electronic goods. But the informal economy includes a great deal of manufacturing as well. Our favorite story involves the chemical company president who noticed that a grocery store in a Mexico City slum was one of his firm's best customers for resins. His curiosity piqued, he sent an employee to investigate. The store was packed floor-to-ceiling with bags of resin. Each day, residents of the slum would buy a bag at a time as feedstock for hand-operated plastic presses, for the manufacturing of toys and household goods. These, in turn, were marketed at traffic lights. Hong Kong has produced no entrepreneurs more ingenious than those of Netzahualcóyotl on the northern outskirts of Mexico City.

Micro-enterprises account for only part of unreported economic activity. High taxes and a capricious and corrupt bureaucracy have forced many medium-size businesses into subterfuges, most of which involve unreported sales. Until this year the Mexican tax system granted special status to "small businessmen," who paid taxes on a bimonthly basis to state government inspectors happy to accept small bribes in lieu of taxes. The disincentive to grow, i.e., to move from nearly tax-free status to a 35% tax rate, compounded by nightmarish amounts of paperwork, was staggering. Small businesses proliferated but remained mired in the informal economy, preferring hassle-free anonymity to government-harassed growth. Small businesses were exempt from breaking out value-added taxes on their invoices but could not sell their products to bigger companies that required receipts showing the VAT. Emerging companies could not issue stock without already showing a substantial balance sheet and offering a minimum issue of about $4 million. Thus much of Mexicans' economic vitality remained bottled up. Small companies lost growth prospects, Mexico lost economic growth, and the government lost tax revenues.

Nik Wheeler/Black Star



Cough-drop-wrapper parasols and Chrysler assembly line
Informal and formal economies.

Sergio Dorantes/Sygma

During the past year the Mexican government has taken dramatic steps to set things right, with a swiftness and resolve that the Eastern Europeans ought to emulate but probably won't. The government has already taken the following steps:

1) Reducing the top marginal tax rate to 35%, the latest in a series of gradual reductions, from 60% in 1986;

2) Abolishing the special tax status of small companies, a first step toward integrating them into the mainstream economy, so they may grow and combine into larger enterprises;

3) Abolishing similar special tax status for transportation and agricultural companies;

4) Throwing out a huge number of offensive regulations, notably most restrictions on foreign investment, transportation regulations, protection of the state petrochemical monopoly and so forth;

5) Eliminating most of the remaining nontariff barriers to trade, including domestic-content quotas for autos and electronics;

6) Selling off the majority of state industrial holdings (the big exception is and will remain Pemex, the nation-

al oil company).

Other things will still need to be done. A large part of the remaining inflation rate derives from the approximately 14% per annum rate of devaluation of the peso. Here, administration policy is working at cross-purposes. Senior officials are still beguiled by fears of "overvaluation" of the peso for trade purposes, and pressured by industrial groups who believe they must sell cheap.

In order to advance to higher levels of economic growth, the Mexican government must make clear to its own citizens that it has repudiated the long-held policy of diluting their unit of account for apparent short-term convenience, and that it is committed to maintaining the integrity of the currency over the long haul. This assurance is necessary to ensure that the future reward of Mexicans' investment of their present labor and capital will be fair. The reluctance of the Mexican monetary authorities to end devaluation altogether has left inflation at a still unacceptable rate.

In spite of Salinastroika, foreigners are still barred from majority ownership of mining companies, and oil exploration, development, refining and retailing remain national monopolies.

Another injurious remnant of the bad old days has not been corrected, though, and until it is, the Salinas administration will have difficulty making other reforms fall into place. Income taxes are still far too high. The top marginal rate has come down to 35%, but it applies to annual income in excess of $7,000. In the U.S., a family earning $7,000 would pay no taxes at all. Thus the incentive for small proprietors to remain off the books, and, above all, to hire tax-free labor off the books, remains tremendous. That short-circuits the natural process of growth, in which the best small companies absorb their competition and become big companies, with accompanying economies of scale. Why? Because the tax structure forces businesses to remain small and, they hope, invisible. Mexico needs a drastic reform of tax brackets, combined with 100% indexation for the effects of inflation.

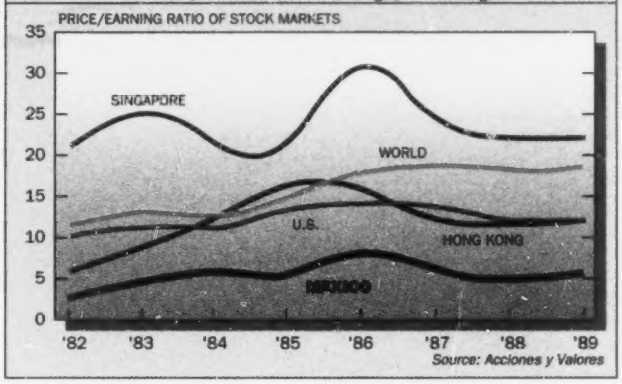
Mexico's real engine of growth is its growing population, industrious and canny enough to find work for nearly everyone under the worst conditions imaginable. The population is young; in 1985, two-fifths of all Mexicans were younger than 14 years of age. If the flood tide of new labor force entrants finds employment, as it did during the 1980s, Mexico's economic growth will be among the world's fastest during the coming decade.

The grand scale of this expansion will be matched by comparable gains in productivity. The low cost of Mexican labor will rapidly diminish as an investment incentive, in favor of the efficiency and trainability of Mexican workers. The country's standard of living will climb.

Where does one invest to take advantage of Salinastroika? Mexico's to-

Mexican market P/E ratio set to take off

As Mexico moves to a Singapore-like growth rate in the 1990s, the Mexican market's P/E ratio should approach 20. The market, at 8 times earnings, is a bargain.



Source: Acciones y Valores

Some interesting Mexican buys

The companies listed below are market leaders in their industries. Their stocks have already moved up, but they are still relatively cheap. The potential is there for further price increases.

Company/business	Ticker symbol	1989 sales (US $mil)*	Recent price	Trailing 12-month P/E	Price appreciation for 12 months ended May 31, 1990†
Teléfonos de Mexico‡/telephone services	TELMEX	$2,090	$1.80	12	237%
Grupo Industrial Alfa/steel & petrochemicals	ALFA	2,060	8.85	5	90
Cifra‡/retailing	CIFRA	1,460	1.00	11	129
Fomento Económico Mexicano/food & beverages	FEMSA	1,280	2.00	14	40
Desc Sociedad de Fomento Industrial/chemicals	DESC	1,170	5.60	8	49
Cemex/cement	CEMEX	1,057	4.40	12	34
Vitro/glass products	VITRO	900	15.40	8	25
Industrias Peñoles/mining metallurgy	PEÑOLES	800	1.30	6	13
Grupo Industrial Bimbo/food, beverages & tobacco	BIMBO	760	1.90	12	19
Grupo Industrial Minera Mexico/mining	GMEXICO	750	2.55	9	7
Kimberly Clark de Mexico/paper products	KIMBER	670	7.60	13	62
Cydsa/chemicals	CYDSASA	600	4.30	8	17
Grupo Condumex/electrical	CODUMEX	470	3.70	12	2
Tubos de Acero de Mexico‡/steel tubing	TAMSA	297	5.50	22	9
Teleindústria Ericsson/electrical	ERICSON	280	1.90	14	138

*Average exchange rate of 2,511 pesos to $1 was used for 1989. †Adjusted for inflation ‡Available in ADRs.

Sources: Acciones y Valores; Estrategia Bursatil; Capital Group International.

See what everyone's talking about.

ONE OF THE YEAR'S 10 BEST! TWO JUBILANT THUMBS UP FOR THIS TRIUMPHANT COMEDY!
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Vincent Canby
THE NEW YORK TIMES

SCATHINGLY FUNNY!
Kathleen Carroll
NEW YORK DAILY NEWS

Roger & Me

The story of a rebel & his mike.

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J. Hoberman
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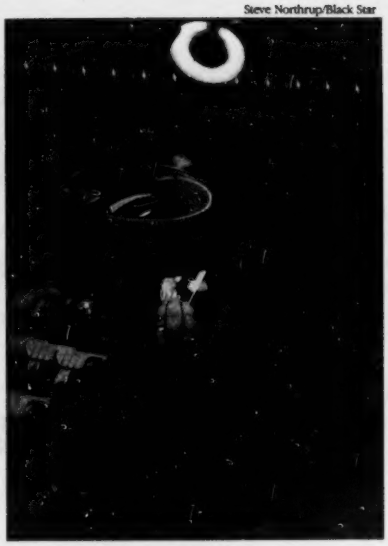


Elamex Electronics Factory
Good jobs at home.

tal equity market capitalization is approximately $35 billion, that is, $^1/_{100}$th the size of either New York or Tokyo's stock market. Even after rising sharply, it still has an average price/earnings multiple of less than ten. The chart at the top of page 51 makes clear just how great the growth potential is.

Mexico can duplicate or even better the experience of the Asian "tigers" during the 1980s. Mexico's growth rate should be at least 7%, the growth rate between 1960 and 1980, and it could exceed 10%.

The Mexican stock market has barely begun to discount the growth possibilities. Its capitalization should grow at least tenfold during the next five years merely in order to accommodate the capital requirements of growing companies, and the price/earnings ratio should rise toward the vicinity of 20.

During the next year or so, most of the action will center on the reprivatization of commercial banks nationalized by President López Portillo in September 1982, along with other public companies. Much more important than the privatization of government companies, though, will be the flood of new equity offerings by small aggressive firms seeking to become big. That is where real money will be made. It will take a year or two for the trickle to turn into a flood.

Now is the time for American investors and industrialists to factor into their plans the likelihood that in the decade ahead, Mexico, thanks to Salinastroika, could easily have the fastest-growing economy in the hemisphere. ■

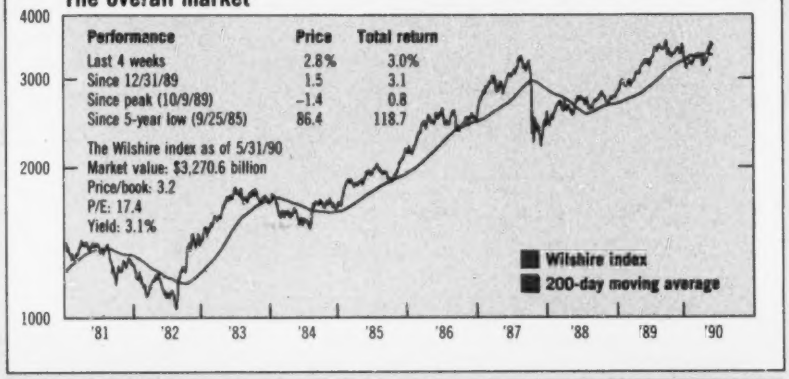
The Forbes Wall Street Review

Edited by Eric S. Hardy

Big loan writeoffs have scared investors out of bank stocks, but Anthony Polini, who follows regional banks and thrifts for A.G. Edwards in St. Louis, is not frightened. "During the next 15 or 20 months, the market is once and for all going to make a distinction between good bank stocks and bad ones," he says. Among the financial institutions Polini recommends are Bay View Capital (California), Old Kent Financial (Michigan), Mercantile Bancorp (Missouri) and Peoples Bancorp (Massachusetts). Nonetheless, bank and thrift stocks are still hitting Wall Street with some nasty earnings surprises. San Diego-based HomeFed, which fell 18% and was one of the worst-performing stocks over the last two weeks, recently announced that its nonperforming assets increased by $81 million in May.

The New York Stock Exchange is making a laudable effort to extend trading hours to take better advantage of foreign interest and to compete with so-called third-market trading (done by nonmember firms). But this comes on the heels of another announcement regarding "circuit breakers." The exchange says it may implement trading halts when the market drops too much. Closing the exchange, possibly for almost an entire day, hardly seems like the way to insure investor confidence in the liquidity of the stock market.

The overall market[1]



The Best Performing Stocks

Company	Price	2-week change	P/E	Avg vol (thou)[2]	Rel vol[3]
BMC Software	29¼	22%	35	1,037	1.0
Home Shopping Network	8¼	20	NM	3,159	1.9
Cetus	19½	18	NM	6,292	2.2
Wendy's Intl	7¼	16	28	10,865	3.7
Oracle Systems	22¾	15	32	16,117	0.9

The Worst Performing Stocks

Company	Price	2-week change	P/E	Avg vol (thou)[2]	Rel vol[3]
LA Gear	27½	-30%	8	12,439	2.3
Urcarco	16½	-21	NM	9,030	4.2
Homestake Mining	15¾	-19	63	3,568	0.9
Battle Mountain Gold	10¼	-19	33	4,689	2.0
HomeFed	24	-18	4	2,144	3.1

Closeup on the Market

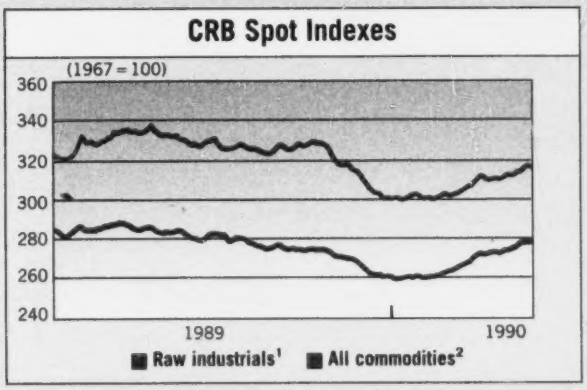
Index or investment	Price	2-week change
Wilshire index 6,000 stocks, capitalization weighted	3,472.55	0.7%
Wilshire index 6,000 stocks, equal weighted	22.07	1.4
Dow Jones industrials 30 stocks, divisor-adjusted price average	2,928.22	1.8
S&P 500 Capitalization weighted cross section, major stocks	362.90	0.5
NYSE Capitalization weighted, all listed common stocks	197.98	0.5
Amex Capitalization weighted total return: stocks, warrants	364.30	0.3
Nasdaq Capitalization weighted, all issues except warrants	467.10	1.8
Amex international market index Capitalization weighted, 50 largest ADRs	316.68	0.2

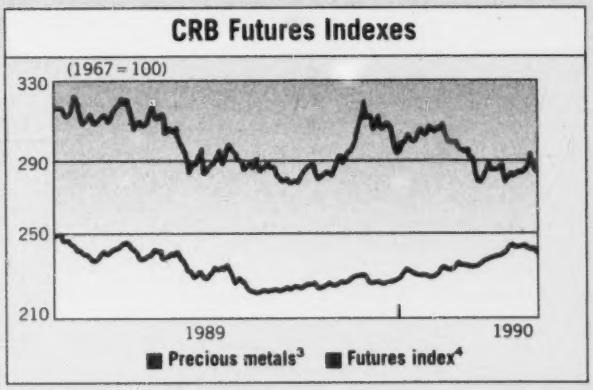
Index or investment	Price or rate	2-week change
Europe, Australia, New Zealand and Far East[4] (EAFE) a dollar denominated capitalization weighted index	910.20	-1.5%
Institutional[5] Approximately 200 stocks with high institutional ownership	119.59	1.0
Individual[5] Approximately 200 stocks with low institutional ownership	106.19	1.8
Russell 2000 index 2000 stocks with small market values, capitalization weighted	170.63	1.2
Gold[6] (composite quote of 6 major dealers)	$344.75	-5.4
Yen[6] (per $U.S.)	154.13	1.1
Commodity index[6] (CRB futures index, 1967 = 100)	236.44	-2.0
Oil[6] (W Texas Intermediate)	$17.15	-1.4
T bills[6] (90 days)	7.64%	-11 basis points[7]
Broker loan rate[6]	9.25%	unchanged

Note: All data for periods ending 6/14/90. Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created. Stocks listed above have market capitalizations of $500 million or more. [1]Capitalization weighted, prepared by Wilshire Associates, Santa Monica, Calif. [2]Average daily volume over a 2-week period. [3]Average daily volume over the last 2 weeks, divided by the average daily volume over the preceding 3 months. [4]Morgan Stanley Capital International Perspective. [5]For period ending 6/15/90. A. Arbel, Cornell University, using Ford Database from Ford Investor Services. [6]Knight-Ridder Financial Information. [7]A basis point is equal to one-hundredth of a percentage point. NM: Not meaningful.

Commodities Review

Edited by Eric S. Hardy



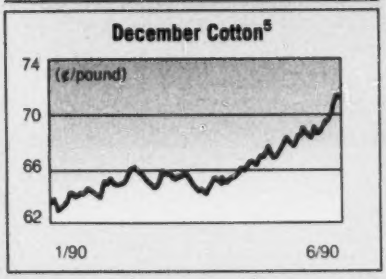


If the cost of living shoots up, commodity prices are unlikely to be the prime culprit. "There's nothing on the horizon that will result in higher inflation" in terms of raw materials, says James Nevler, who analyzes the commodity markets for the Commodity Research Bureau, a subsidiary of Knight-Ridder. The bureau's futures index is down 1% from mid-March. "I see very stable markets and ample supplies of many goods like coffee and orange juice," adds Nevler.

This doesn't mean that commodity markets will no longer be volatile or that consumers won't pay more at the retail level. Higher taxes for gasoline products in states like New York and California, for example, may nullify any savings that might result from the recent decline in oil prices. And retail prices for many products go up faster with bad news than they go down with good news.

Many precious metals have had sharp price declines so far in 1990. Gold was recently about $350 an ounce, silver under $5. Although platinum, used in automotive catalytic converters, hasn't fallen as much in percentage terms it is now trading near the bottom of its 52-week price range. Prices of base metals, such as zinc and copper, have held up well, while tin has fallen 10% in the year to date. This weakness in commodity prices supports those who believe the Fed is feeling confident enough to ease up on interest rates *(see story, p. 66).*

Commodity Spotlight



There has been too little rain in south Texas, and too much in Missouri. Both conditions may help cause the summer cotton crop to be smaller than originally estimated. According to the U.S. Department of Agriculture, cotton exports are at a ten-year high and inventories at a six-year low. As a result, cotton has been one of the strongest commodities in the futures market.

Cash and Futures Prices

Spot Indexes			Futures Indexes		
Index[6]	Value	3-mo change	Index[6]	Value	3-mo change
All commodities	275.36	3%	CRB index	235.46	–1%
Raw industrials	317.04	4	Precious metals	273.47	–8
Metals	311.88	6	Industrials	247.29	–2
Textiles	261.10	6	Grains	201.44	1
Foodstuffs	224.46	2	Livestock & meat	234.63	10

Spot Commodity Prices			Futures Prices		
Commodity	Price	3-mo change	Commodity	Price	3-mo change
Steel scrap (short ton)	$114.00	16%	July platinum (troy oz)	$476.00	–7%
Copper scrap (pound)	0.87	–5	Aug crude oil (barrel)	17.59	–15
Print cloth (sq yard)	0.74	6	July copper (pound)	1.12	–2
Corn (bushel)	2.76	13	July cotton (pound)	0.81	12
Soybean oil (pound)	0.25	7	July Chi wheat (bushel)	3.28	–4

Notes: All prices as of 6/15/90; graphs as of 5/31/90. [1]Comprised of 13 commodities. [2]Comprised of the 13 raw industrial commodities plus 10 foodstuffs. [3]Gold, platinum and silver. [4]Comprised of 21 commodities. [5]Prices from 1/1/90 through 6/8/90. [6]Base for spot and futures indexes (1967 = 100). Source: Knight-Ridder Commodity Research Bureau.